

C H A P T E R

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# FINANCE AND THE HOSPITALITY INDUSTRY

F E A T U R E S T O R Y

## THE HILTON FAMILY

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Perhaps the best-known hotel brand in the world is Hilton. When you think *hotel*, you think Hilton. The Hilton hotel chain was founded by Conrad Nicholson Hilton. His work is now carried on by his sons, Barron and Eric.

The child of a Norwegian immigrant father and a German-American mother, Conrad Hilton had a strong belief in the American dream. His philosophy and strength were derived from his faith in God, his belief in the brotherhood of man, his patriotic confidence in his country, and his conviction that natural law obligates all humankind to help relieve the suffering and distress of the destitute.

Conrad Hilton almost became a banker rather than a hotelier. He traveled to Cisco, Texas, in 1919, intending to purchase a local bank, but the deal fell through when the seller raised the purchase price higher than what Mr. Hilton would agree to pay. Instead,

he purchased the Cisco Mobley Hotel when he discovered it was achieving high occupancies due to the influx of exhausted oil-seekers and railroad travelers. Mr. Hilton learned that the innkeeper of the Mobley was selling its rooms three times a day. Conrad went on to purchase three other existing hotels, which generated enough cash flow to help him construct his first new hotel, the Dallas Hilton, which opened on August 2, 1925.

Conrad Hilton was a fortunate man who had a knack for impeccable timing. During the Great Depression of the 1930s, when over 80% of the nation's hotels went into bankruptcy, he was able to maintain ownership of five of his eight hotels by convincing the Moody family of Galveston, Texas, to lend him \$300,000, using the hotels as collateral. Incredibly, when he defaulted on the loan, the Moodys foreclosed on the hotels but offered him a one-third partnership with a salary of \$18,000 per year in the newly created Moody hotel chain. While the partnership did not last long, Mr. Hilton was able to reacquire three of his five hotels from the Moodys with another loan of \$95,000.

Conrad Hilton went on to expand his chain by purchasing other U.S. hotels including the Sir Francis Drake in San Francisco, the Plaza and Waldorf-Astoria hotels in New York City, and the Stevens, now known as the Chicago Hilton and Towers, and the Palmer House in Chicago.

The key to Mr. Hilton's success was his ability to purchase underperforming hotels and convert them into cash-flowing assets. He accomplished this by introducing innovative forecasting and cost control systems to the hotel industry. His hotel management team became experts at predicting the number of occupied rooms they would experience and scheduling their employees accordingly. This matching of business volume with employee hours resulted in high levels of guest satisfaction and significant cash flows for his company.

Internationally, Conrad Hilton developed his business by building hotels in such exotic places as San Juan, Madrid, Istanbul, Havana, Berlin, and Cairo and getting them financed by local partners. His corporate and personal motto became "World peace through international trade and travel." In a 1954 speech to students at Cornell University, he said:

Each one of us . . . carries with us, wherever we go, a little of America. Whether we like it or not, we represent America, its culture, its faith and its history. . . . We are ambassadors in a true sense of the word and have got to act like ambassadors. . . . A hotel is a focal point for the exchange of knowledge between millions of people who want to know each other better, trade with each other and live with each other in peace.

Mr. Hilton also believed that tourism would stimulate international economies and provide jobs for many, thus generating kudos for the United States and reducing the amount of foreign aid it had to provide.

His sons, Barron and Eric, followed their father into the hotel business. In 1954, Barron assumed the position of president and chief executive officer of Hilton Hotels Corporation, and in February 1979 he became chairman of the board. He is credited with founding Hilton's credit card Carte Blanche and in developing the Hilton Inn franchise program. He led Hilton into the gaming business through the construction of the Vegas Hilton and the Flamingo Hilton hotels in 1970. These two casino hotels became so successful that they accounted for approximately half of Hilton Hotels Corporation's total operating income and vaulted the company onto the *Fortune* 500 list. Hilton Hotels Corporation became the first gaming company traded on the New York Stock Exchange.

Conrad's other son, Eric, entered the family business at the bottom and worked his way up to the top. While still a high school student, he began his hospitality industry career as a hotel engineer working in the boiler room of the El Paso, Texas, Hilton. He also apprenticed as a bellman, a doorman, a steward, a cook, an elevator operator, a desk clerk, and a telephone operator. After serving his country in the army during the Korean War, and later enjoying a brief career as a professional baseball player, he renewed his Hilton career, becoming president of Conrad Hotels and vice chairman and director of Hilton Hotels Corporation.

Eric Hilton was also instrumental in the creation of the Conrad N. Hilton College of Hotel and Restaurant Management at the University of Houston. When its founding dean, Dr. James Taylor, first approached Eric with his vision for a new hotel school, Eric was receptive and convinced his father to contribute \$1.5 million to the development of the college. The Hilton foundation has since provided over \$45 million for the construction of classrooms, food laboratories, and an operating hotel to train students. This money has also funded scholarships and faculty chairs.

Hilton Hotels Corporation did not become one of the most successful hotel companies in the world without careful planning. Hilton's management is constantly working to increase its revenues and control its costs. Careful consideration is given to identifying companies to acquire, such as Promus, which brought Embassy Suites, Hampton Inns, and Doubletree Hotels into the Hilton family; new products to provide, like Hilton's new Garden Inn; where to open new Hilton-branded hotels; and how to finance the corporation's growth and expansion. Much of the information required to make these decisions is provided by the company's accounting, management information, and investment analysis systems, which utilize many of the concepts, techniques, and skills presented in this text.

#### SOURCES

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#### Learning Outcomes



1. Describe the nature of the book.
2. Note the book's target audience.
3. Explain the owner/manager alignment of interests theme of the book.

4. State the specific objectives of the book.
5. Discuss the financial challenges presented by the hospitality industry.
6. Present the structure and organization of the book.
7. Preview the contents of each chapter.

## Preview of Chapter 1

### 1. INTRODUCTION

- a. Nature of the book
- b. Target audiences
- c. “Think like an owner and act like a manager”

### 2. OBJECTIVES

- a. Read, interpret, and analyze financial management reports
- b. Manage working capital and profits
- c. Understand the importance of growth and how to finance it
- d. Become familiar with the sources, types, and costs of capital
- e. Comprehend the concept of risk, reward, and value creation
- f. Learn the skills and tools needed to perform investment analysis and make sound business decisions
- g. Understand how an investment package is professionally prepared and presented to decision makers and financing sources
- h. Learn how to structure and negotiate a new hospitality business venture

### 3. FINANCIAL CHALLENGES

- a. Hospitality: A multifaceted industry
- b. Low profit margins
- c. Fluctuating sales volumes
- d. Labor intensiveness
- e. Capital intensiveness
- f. Reliance on discretionary incomes

### 4. CHAPTER STRUCTURE

### 5. CHAPTER TOPICS

- a. Managing revenues, expenses, cash, and profits
- b. The need for growth and how to finance it
- c. The time value of money, the mathematics of finance, and investment analysis
- d. The investment package and the art of the deal
- e. Increasing shareholder value



## INTRODUCTION

Most financial management books focus on the world of big business and the corporate finance function. They are typically long, technical, and more theoretical than practical in their approach to finance. Their tables of contents feature chapters on the “Theory of Value Creation,” the “Optimum Capital Structure,” “Capital Expenditure Analysis,” and “Public Trading in Stocks and Bonds.” While some of these topics are relevant to the front-line hospitality industry manager, this book approaches them in a very different way. Several other important financial topics, unique to the hospitality industry, are also included in this book. As authors, we strived to make the content of the book concise, to the point, practical, and interesting. We hope you enjoy reading it and applying it to your personal career path.

The primary target audience for this financial management book is students who will soon graduate from a hotel/restaurant college and pursue a career in the hospitality industry. The book is also targeted at individuals currently working in the hospitality industry who want to advance their careers. It is intended as the primary text for undergraduate hospitality management courses and as a supplementary text for graduate-level courses.

A recurring theme throughout the book is to “think like an owner and act like a manager.” Once this entrepreneurial mentality is learned, maintaining it will closely align the financial interests of both ownership and management, regardless of the size of the company, and greater financial rewards will result for both parties.

The more specific objectives of the book are to provide students with a clear understanding of:

1. The financial management reports they will encounter and rely on during their hospitality careers to more effectively manage their respective profit or cost centers.
2. The methodology used to accurately read, analyze, and apply the information contained in these reports to enable sound forecasting, pricing, and cost control decision making.
3. The skills and operating systems critical to the management of cash and the profitability of the business.
4. The importance of growing the business, and the growth strategies available to management to accomplish this goal.
5. The types, sources, and costs of capital available to a company to finance its growth, and the advantages, disadvantages, and risks involved.
6. The concepts of risk, reward, and value creation as they apply to investing in hospitality assets.
7. The financial analysis tools modern-day managers use to make sound investment decisions.
8. The importance and contents of a professionally prepared investment package for presentation to top management, owners, lenders, and outside investors to secure the capital needed for growth.

9. How to structure and negotiate a new hospitality business venture from the perspective of the project's sponsor.
10. How the practical application of the financial concepts, skills, and tools described in this book can increase shareholder value and achieve personal financial success for the hospitality manager.

### THE REAL DEAL

According to the November 2004 Special Issue of *The Bottomline*, the official journal of Hospitality Financial and Technology Professionals, the average salary of a controller in the hospitality industry in 2004 was \$74,143 as compared to \$69,311 in 2003 and \$66,550 in 2002. These numbers do not include bonuses or deferred compensation.

Assistant controllers reported average salaries of \$52,916, \$49,970, and \$46,921 for the same three-year period. While the traditional career path for a property-level controller is to become a regional controller and then perhaps take a corporate-level position, some controllers become hotel general managers and, later, members of the corporate management team. So, the next time you contemplate your career path, consider using a position in accounting and finance as a springboard to an operations career. The more you know and can apply accounting and finance skills to your business, the more likely you are to become successful and perhaps even independently wealthy.

Source: Countryman, C., A. L. DeFranco, and T. Venegas. "The 2004 HFTP Compensation and Benefits Survey." *The Bottomline* 19(7):6–33.

## Hospitality Industry Financial Challenges

Hospitality is an exciting and multifaceted industry that offers a variety of career opportunities to those who have earned a hotel/restaurant management degree. Careers with hotel, restaurant, airline, cruise line, gaming, and wine and spirit companies are readily available to such graduates. In addition, careers with service firms that support hospitality companies in the areas of accounting, consulting, real estate development, architecture, interior design, real estate brokerage, hotel valuation, investment banking, mortgage brokerage, insurance, advertising, and technology are also available to those with hospitality degrees.

### FEATURE STORY

## COLONEL HARLAND SANDERS—NEVER TOO OLD TO BECOME FAMOUS

One of the most unusual hospitality industry success stories is that of Colonel Harland Sanders. The Colonel's hospitality career began when most people start thinking about retiring, traveling the world, and playing

with their grandchildren. At age sixty-five, Colonel Sanders embarked on a new small business venture that would grow and become one of the largest fast food empires in the world.

Colonel Sanders began his new enterprise by franchising his fried chicken recipe with equity provided by his \$105 monthly Social Security check. That led to ownership of the international restaurant chain Kentucky Fried Chicken, today known as KFC.

Born in 1890, Mr. Sanders lost his father at age six and was forced to look after his three-year-old brother and baby sister while his mother worked. Having to cook most of the meals while his mother was away from home, he learned and mastered several regional cuisines at a young age. He was a farm worker at age twelve, a streetcar conductor at fifteen, and a soldier at sixteen. Later, he worked on the railroad, served as a justice of the peace, became an insurance salesman, operated a steamboat ferry, sold tires, and ran a service station.

At age forty, he began cooking for hungry travelers in the dining room of his living quarters connected to his service station in Corbin, Kansas. As the number of diners increased and his food volume grew through word-of-mouth advertising, he moved across the street to a motel and restaurant that seated 142 people. Over the next nine years, he perfected his secret blend of eleven herbs and spices and his pressure-cooking technique, which is still used today at all KFC restaurants.

Colonel Sanders was forced to auction off his restaurant business in 1950 when the new interstate highway bypassed Corbin. He was sixty-five years old at the time, and reduced to living off his Social Security check. The Colonel decided to hit the road to franchise his fried chicken recipe. He traveled by car across the country, going from restaurant to restaurant and cooking up batches of his chicken for restaurant owners and their employees. If their reaction was favorable, he entered into a handshake agreement with them which called for the owner to pay him a nickel for each serving of Kentucky fried chicken the restaurant sold. Using this unique franchising concept, the Colonel accumulated a large number of franchisees throughout the United States, which paid him a sizable amount of franchise fees each month. This proved to be a wise business decision on the Colonel's part; in less than ten years, the Kentucky Fried Chicken franchise network grew to a chain of more than 600 franchises. At this point, the Colonel cashed out on the value he had created in his business by selling his interest in KFC for \$2 million while remaining as the company's most recognizable spokesperson and icon.

#### SOURCES

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"Colonel Harland Sanders, 2000 Hall of Honor Inductee of the Hospitality Industry Hall of Honor." <http://www.hrm.uh.edu/home.asp?PageID=183>.

Although dynamic and interesting, the business of hospitality presents many challenges. For example, hospitality businesses operate on low profit margins with fluctuating sales volumes. The ability to forecast revenues and control expenses is critical to achieving budgeted profits and a favorable return on investment for the owners of the company. Also, because hospitality businesses are labor intensive, scheduling employee hours so they are consistent with forecasted revenues and monitoring payroll cost daily are just two major management challenges.

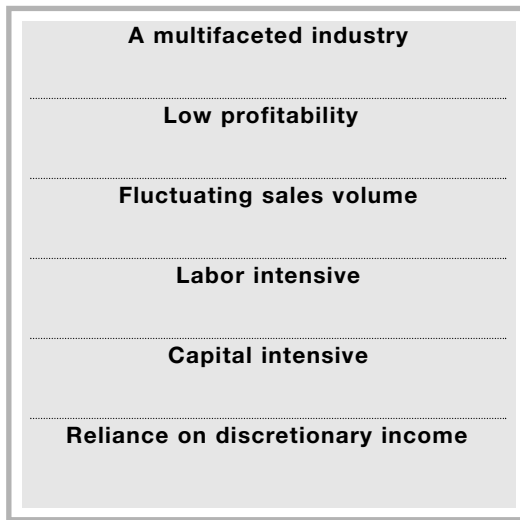


ILLUSTRATION 1-1

Hospitality Industry Financial Challenges

While a hospitality business typically requires a relatively low level of operating inventories, it requires a relatively high level of capital for its real estate component. This component often includes buildings, operating systems, guest room furniture, and restaurant equipment. Securing financing to acquire these assets is a continuing challenge for management.

Finally, hospitality businesses rely heavily on the discretionary income of their customers. During a weak economy, when household discretionary income is low, the hospitality industry usually suffers. High-end establishments, such as resorts and fine dining restaurants, normally feel the effects of a weak economy first, but eventually, the entire industry feels the financial pain. However, as soon as the economy takes a turn for the better, consumers return, discretionary spending increases, and the industry prospers. Accurately predicting these economic fluctuations, and knowing when to buy and sell hospitality assets, can be financially lucrative for the astute hospitality investor.

The financial tools utilized by modern-day management to address these challenges and opportunities are the focus of this book. Understanding of these financial tools and applying them to the challenges and opportunities they will soon face when they take jobs in the industry will serve hospitality graduates well throughout their business careers. Illustration 1-1 lists many of these challenges.

## Chapter Structure

Each chapter in the book includes the following features:

- Two feature stories that describe the careers of hospitality professionals and how their knowledge of financial skills contributed to their personal business success
- Learning Objectives



- Chapter Preview
- Illustrations of important concepts and calculations
- “Finance in Action,” an illustrative case study that relates to the concepts presented in the chapter
- “Where We’ve Been, Where We’re Going,” which provides a summary of what was covered within a chapter and what is covered in subsequent chapters
- Key Points, a bulleted list of the key concepts relating to the learning objectives provided at the beginning of each chapter
- Key Terms
- Application Exercises
- Concept Checks
- “The Real Deal,” a financial vignette based on a real-life financial scenario
- Links to hospitality websites, where applicable, to supplement the text and keep it current

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## Chapter Topics

The text is organized into five modules. Chapters 2, 3, and 4 focus on managing revenues, expenses, cash, and the profitability of the hospitality business. Chapters 5 and 6 discuss the need for growth, growth strategies, and how to finance the growth of a company. Chapters 7, 8, and 9 deal with the concept of time value of money, the mathematics of finance, investment analysis, and how financial analysis tools are used by management to make wise investment decisions. Chapters 10 and 11 apply the knowledge gained in the prior nine chapters to the preparation of a professional investment package and the negotiation of a new business venture. Both internal capital and private financing requests are discussed. Finally, chapter 12 recaps the key concepts, skills, and tools presented throughout the book and provides a reference guide for the hospitality graduate. Illustration 1-2 highlights the building blocks of the book.

## CHAPTER 2: FINANCIAL REPORTING

Chapter 2 focuses on the basic daily, weekly, and monthly management reports the hospitality manager receives and explains how to read and interpret each. The daily revenue report, daily payroll report, Smith Travel Research STAR report, food menu abstract report, rooms revenue forecast, income statement, and balance sheet are all explained. The chapter also reviews the principles of accounting on which a company’s financial statements are based, the limitations of financial statements, and the Uniform System of Accounts for hotels, restaurants, and clubs. The impact of the Sarbanes-Oxley law on the hospitality industry is also discussed.

## CHAPTER 3: ANALYZING FINANCIAL STATEMENTS

Chapter 3 begins with an explanation of how to analyze financial statements and management reports. Ratio analysis, both vertical and horizontal, is discussed in addition to how hospitality

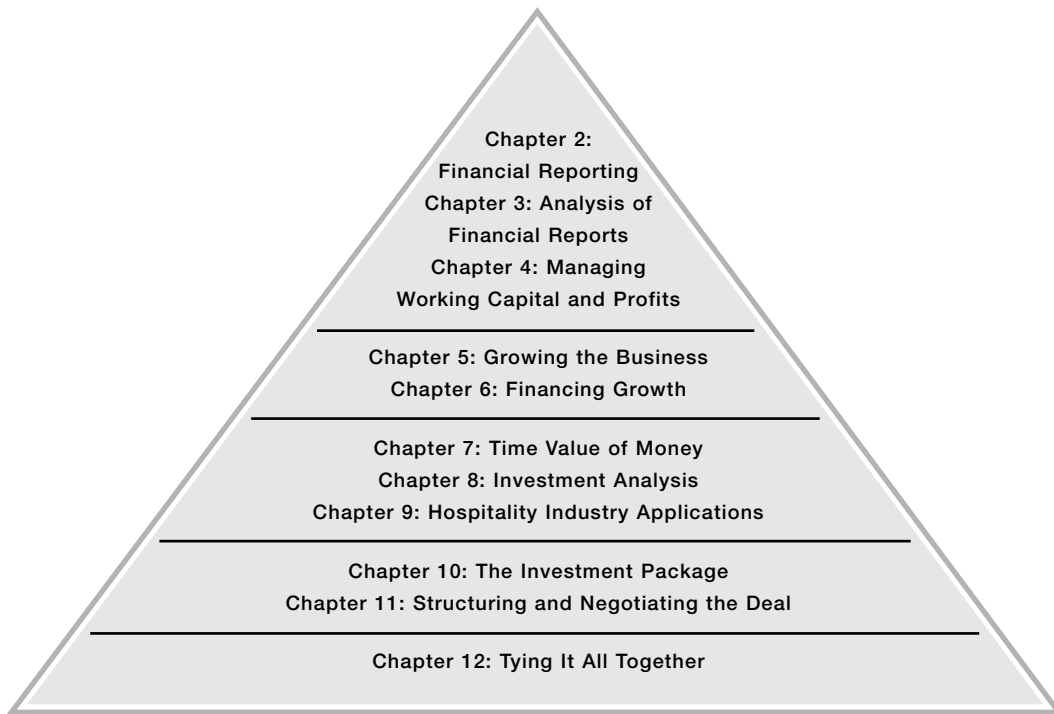


ILLUSTRATION 1-2  
Organization of the Text

managers compare the operating results of their department, or the business as a whole, to industry standards and norms. The chapter also explains how the financial statements and management reports discussed in chapter 2 are used for employee scheduling, budgeting, profit flexing, cost-volume-profit modeling, pricing, and revenue management.

## CHAPTER 4: MANAGING WORKING CAPITAL AND CONTROLLING CASH

How effective management of working capital, product cost, and operating expenses leads to success in business is the focus of chapter 4. Internal controls, cash budgeting, accounts receivable management, accounts payable management, food and beverage cost control systems, and a unique profit management system called CP<sup>3</sup> are also discussed. The CP<sup>3</sup> System involves a monthly commitment budget prepared by department heads and approved by the general manager and the corporate office. It is a management reporting system that tracks and monitors revenues, expenses, and profits on a daily basis through an analysis of purchase orders, a daily recap of payroll hours and payroll expense by department, and a daily profit and loss statement.

## **CHAPTER 5: GROWING THE BUSINESS**

Growing the business is the subject of chapter 5. The importance of growth and growth strategies are also discussed, including franchising, management contracts, mergers, and acquisitions.

## **CHAPTER 6: FINANCING GROWTH**

Sources, characteristics, advantages, disadvantages, and the cost of debt and equity financing are discussed in chapter 6. Financing decisions related to both public and private financing vehicles and hospitality financing schemes such as condominium hotels are also discussed.

## **CHAPTER 7: THE TIME VALUE OF MONEY**

Chapter 7 introduces the concept of time value of money and offers instruction on how to use formulas, interest factor tables, the business calculator, and the Excel spreadsheet to solve time value of money problems. The chapter provides detailed instruction on how to calculate the future value and present value of a single lump sum, an annuity, and an uneven stream of cash flow, in addition to the calculation of a loan amortization table.

## **CHAPTER 8: INVESTMENT ANALYSIS**

Chapter 8 builds on the time value of money concepts discussed in chapter 7 and explains how hospitality managers use time value of money calculations to help make wise investment decisions. This chapter begins with a discussion of risk, reward, and value creation and then proceeds to the concepts of payback period, net present value (NPV), internal rate of return (IRR), and modified internal rate of return (MIRR). The advantages, disadvantages, and factors impacting each financial tool are also discussed. Detailed instruction on how to calculate payback, NPV, IRR, and MIRR using formulas, interest factor tables, the business calculator, and the computer is also provided. The capitalization and appraisal methods of valuation are also discussed.

## **CHAPTER 9: HOSPITALITY INDUSTRY APPLICATIONS OF TIME VALUE OF MONEY CONCEPTS AND SKILLS**

Building on chapters 7 and 8, chapter 9 applies the aforementioned financial investment analysis tools to real-life hospitality situations. This chapter demonstrates how to use these financial analysis tools to determine the optimum loan size, the maximum debt service affordable, the amortization rate required, the maximum amount of equity that can be raised based on the cash flow projected, and the amount of ownership that must be offered to a new equity investor to

meet the investor's hurdle rate. This chapter also explains how to analyze and compare multiple investment opportunities and perform sensitivity analyses of potential investments.

## CHAPTER 10: THE INVESTMENT PACKAGE

Preparing a professional investment package and customizing it for both internal capital requests and external financing needs are the subjects of chapter 10. This chapter also provides information about how potential lenders and investors evaluate an investment package.

## CHAPTER 11: CRAFTING AND NEGOTIATING THE DEAL

Chapter 11 explains how to structure and negotiate a new business venture, taking into consideration tax and liability issues, business entity options, the optimum mix of capital, and special ownership incentives for the sponsor.

## CHAPTER 12: TYING IT ALL TOGETHER

This is the final chapter. It recaps the key concepts, skills, and tools discussed throughout the book and provides an easy reference guide for use when business opportunities and challenges present themselves.

### WHERE WE'VE BEEN, WHERE WE'RE GOING

This chapter prepares us for what is to come. Toward the end of this chapter, there is a list of key terms in alphabetical order, and you will see such lists in the remaining eleven chapters of the book. Hospitality finance is a fascinating and challenging subject, applicable not only to the business you manage but also to your personal life. Take time to learn and enjoy the material.

### Key Points



- This book presents financial management in a concise, to the point, practical, and interesting manner.
- The target audience for this book is undergraduate hospitality students and current employees of hospitality companies who want to advance their careers.
- “Thinking like an owner and acting like a manager” means adopting an entrepreneurial attitude. The primary goals of both owner and managers should be to increase shareholder value. When

the interests and objectives of ownership and management are aligned, favorable financial results can be more easily achieved.

- The primary goal of this book is to teach the student how to manage revenues, expenses, cash and profits; generate, manage, and finance growth; analyze potential investment opportunities and make sound business decisions; structure and negotiate new business ventures; and increase shareholder value.
- Hospitality businesses operate on low profit margins, experience fluctuating sales volumes, are labor and capital intensive, and rely on the discretionary income of their customers to be successful.
- Each chapter in this book includes feature stories of hospitality leaders, learning objectives, a preview of the chapter, illustrations, “Finance in Action” case studies, a summary of key points, key terms, application exercises, concept checks, challenging case studies, real-life financial vignettes, and links to hospitality websites where applicable.

## Application Exercises



1. In your own words, describe what hospitality finance is.
2. Why is hospitality a multifaceted industry and therefore a challenge to hospitality graduates?
3. What is the range of profit margins for each segment of the restaurant industry? Search the National Restaurant Association website at [www.restaurant.org](http://www.restaurant.org).
4. How does labor intensiveness complicate financial management of a hotel, restaurant, theme park, club, or any hospitality operation?
5. Do you believe the manufacturing industry or the hospitality industry carries a higher inventory level as a percentage of total assets? Please explain.
6. How does a boom or a bust in the economy impact the travel segment of the hospitality industry in terms of airlines, hotels, and rental cars?
7. The concept of time value of money is introduced in this chapter. As a follow-up exercise, please visit a local bank and ask for the current list of interest rates the bank pays a customer on a regular checking account, a three-month certificate of deposit, and a one-year certificate of deposit. Explain why the bank has different rates for each of these three investment instruments.
8. Interview at least three friends or family members who have the financial capacity to lend you \$1,000. Ask them if you presented them with a business proposal, would they prefer to lend you \$1,000 plus interest or to invest their \$1,000 for an ownership position in your venture? Also ask them the rationale behind their decision.
9. Interview a controller of a hospitality business in your area and write a brief article on “A Day in the Life of a Controller.”

10. **ETHICS** ★ As a restaurant manager, Ian knows his business well and enjoys servicing his guests. He leaves all the financial dealings to his partner, Patrick. Ian's philosophy is that as long as customers are coming in to dine, his restaurant will do just fine. He entrusts all of the financial matters of the business to Patrick. From a financial standpoint, do you share Ian's view? Is there any downside to Ian not actively participating in the financial management of his restaurant? If so, please explain.